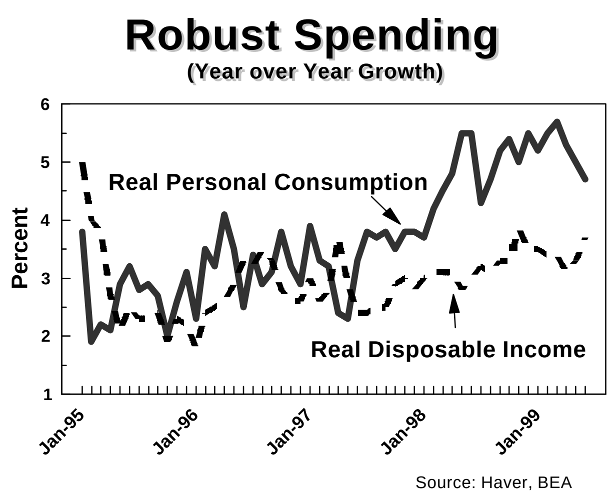
August 1999

US Overview: Rate Hikes May Be Forthcoming to Cool Economy

The strength of the US economy continues to impress: consumer spending is exceptionally robust; manufacturing is rebounding from last year's slump; and labor markets remain very tight. While productivity advances have held inflation in check so far, the Federal Reserve has warned that if wage gains accelerate and productivity fails to keep pace, price pressures will mount. The Federal Reserve already raised rates preemptively by 25 basis points in June. Based on the hawkish tone of last month's Humphrey-Hawkins report, further tightenings appear likely.

Red Hot Consumer

While GDP growth did slow in the second quarter, the report was not as weak as first appeared. Real consumption grew at an impressive 4 percent pace -- while below its first quarter pace, it showed that the consumer sector still remained red hot into the summer quarter.



There are other signs of an overheated consumer. Fueled by remarkable stock market gains, personal spending increases have outstripped rises in disposable income, pushing the personal savings rate down to a record negative 1.1 percent in the second quarter. Such spending has also boosted imports and put the trade deficit on track for a new record high this year. While the increase in the trade deficit has acted as a safety valve and contained inflationary pressures thus far, it could become a negative if its burgeoning size begins to worry our foreign creditors and leads to further depreciation of the dollar.

Going forward, conditions remain favorable for continued strength in consumption – the tight job market is boosting incomes across the board, stock market strength has greatly inflated household wealth, and consumer confidence remains near 30 year highs. Even the rise in long-term bond yields since the start of the year has not had appreciable dampening effects thus far.

Manufacturing Rebound

Last year, robust consumer demand did not lead to inflationary pressures, since it was coupled with a weak manufacturing sector and falling commodity prices. These latter factors are reversing, however, as the global economy recovers from last year's crisis. The National Association of Purchasing Managers survey shows that manufacturing has expanded steadily for the last 6 months. While manufacturing employment has shrunk during 1999, employment is a lagging indicator and it seems likely this trend will soon reverse.

Early Signs of Pipeline Price/Wage Pressures

Even though consumer prices (excluding food and energy) have been relatively contained this year, there is evidence of nascent price pressures further up the pipeline. Commodity prices, as measured by the Journal of Commerce index, have risen roughly 6 percent this year. This has filtered through to the producer price index for core intermediate goods and the "prices paid" index in numerous business surveys.

There are also signs of increasing wage pressures, as highlighted by the sharp gain in the Employment Cost Index in the second quarter. While some of this index's strength was a correction of first quarter weakness, it still suggests that wages are starting to react more to today's tight labor market.

This is consistent with the fact that worker confidence appears to have risen in 1999, as measured by the job leavers index. (Since this index is the fraction of the unemployed who have left their jobs voluntarily, it tends to rise in strong job markets). This uptick may worry the Fed, since they have previously cited the lack of worker confidence as a main reason why wage demands have been restrained up until now.

When to Tighten?

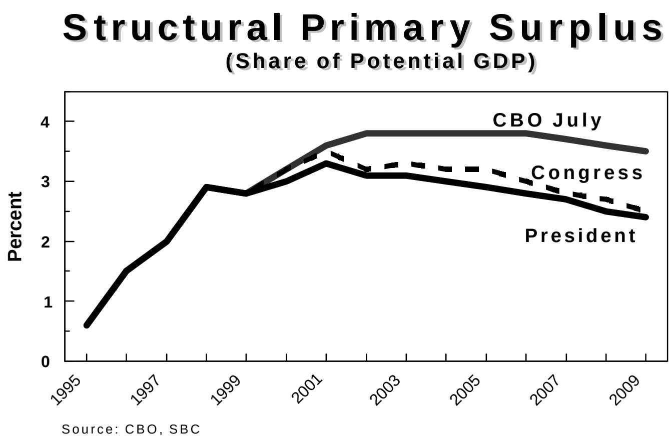
Financial markets expect a 25 basis point rate hike this fall and another similar tightening in early 2000. However, the next hike could come sooner than that, since the Fed will likely be reluctant to raise rates near year-end. While US industry seems reasonably well prepared for Y2K, the same can not be said for many emerging economies. Thus, it is possible that investors may shift funds out of emerging nations and into the US ahead of year-end, which could generate temporary financing strains for these nations. The Fed is likely loathe to exacerbate these tensions by tightening in the fourth quarter. This points to the August 24th FOMC meeting as the venue for another Fed rate increase.

Selected Issue: Is Fiscal Policy Stimulative ?

In recent days, there have been a flurry of charges that Congress' budget and tax cut plan will deliver unwanted stimulus to the economy which will precipitate a rate hike by the Federal Reserve. Are these charges accurate? We think the answer is "no".

First of all, it is important to put the budget debate into perspective. Both the President and the Congress intend to use all of the Social Security surplus and a portion of the on-budget surplus for debt reduction. Over the next 10 years, Congress' budget projects surpluses will rise steadily from 1.4 percent of GDP this year to 2.0 percent by 2006-2009 <u>even with a $792 billion tax cut</u>.

At first glance, it certainly does not seem that Congress' budget plan is stimulative. However, a better way to assess the fiscal impulse to the economy is to look at the trend in the structural primary surplus. This measure strips out the effects of the business cycle and excludes net interest (which reflects previous policy changes, not contemporaneous ones). CBO compiles its estimate of the structural primary surplus with each budget update.



The Economic Bulletin reduced CBO's July 1999 estimates by the amount of the surplus that Congress and the President spend/use-for-tax-cuts relative to CBO's baseline. Even with Congress' tax cut, the structural primary surplus still grows slightly in 2000 and 2001, <u>suggesting that fiscal policy will not be expansionary during the period that most concerns the Fed in its interest rate deliberations.</u>

How is this possible? Congress' tax cuts phase-in very gradually. In 2000 and 2001, tax cuts total less than $30 billion or less than 0.2 percent of GDP. Even as the tax cuts grow in the out years, the yearly deterioration in the structural primary surplus is small and is within the margin of error of these figures. Throughout the 2000-2009 budget window, the surplus remains quite high relative to historical levels. It is interesting to note that the surplus is larger under Congress' plan than under the Administration's.

In his recent Humphrey-Hawkins testimony, Federal Reserve Chairman Greenspan also downplayed the argument that Congress' budget and tax plan is stimulative in the near-term. When asked if a tax cut would overheat the economy and force him to raise rates, the Chairman said:

> "I think it would be a fair analysis if the cuts were to occur immediately ... [but] that's not in any of the bills I think which have been thrown into the hopper. They all have -- they are all working against the on-budget surplus which evolves rather slowly in the context of the projections that are being made. So it's sufficiently far out that I don't particularly have that concern." (Senate Banking Cmte 7/28/99)

Some Administration officials have acknowledged the fact that tax cuts are back-loaded, yet argue that the taxpayers will nonetheless discount the value of the 10 year tax cut and adjust today's spending accordingly. This presupposes a much more aggressive response to tax change announcements than is supported by the empirical literature. Chairman Greenspan also downplayed this concern in recent testimony.

The lack of a financial market reaction to the current tax debate is consistent with the view that Congress' tax cuts are not stimulative near-term. (While some of the financial market's relaxed stance may derive from the view that gridlock will prevail, the back-loaded nature of the tax cuts also likely plays a role).

Thus, while the Fed may need to raise interest rates over the next year to correct current overheating, fiscal policy should not be a contributing factor. Indeed, fiscal policy should remain a constructive force for the economy, since Congress proposes to save the bulk of the surpluses over the next ten years.

Recent Economic Data

	Q4-98	Q1-99	Q2-99	Most Recent
Real GDP Growth	6.0	4.3	2.3	
Consumption	5.1	6.7	4.0	
Trade Deficit ($bn)	43.3	53.8	-	21.3(June)
Unemployment Rate	4.4	4.3	4.3	4.3(June)
Productivity Growth	4.6	3.4	-	
CPI Inflation	1.6	1.7	2.1	2.0(June)
30 Year Treasury Yield	5.2	5.6	6.0	6.1(July)
Dow	9,180	9,790	10,500	10,700(July)

In July, Blue Chip asked its economists if the S&P 500 would be higher or lower at year- end. Most were pessimistic.